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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR AN
ORDER OR ORDERS AUTHORIZING IT TO ISSUE,
INCUR, OR ASSUME EVIDENCES OF LONG-TERM
INDEBTEDNESS; TO ACQUIRE A FINANCIAL
INTEREST OR INTERESTS IN AN AFFILIATE OR
AFFILIATES; TO LEND MONEY TO AN AFFILIATE
OR AFFILIATES; AND TO GUARANTEE THE
OBLIGATIONS OF AN AFFILIATE OR AFFILIATES

Docket No. E-01345A-02-0707

STAFF'S RESPONSIVE BRIEF

I. INTRODUCTION

In this case, the Commission must decide whether it is in the public interest to authorize Arizona Public Service Company ("APS") to incur debt to finance assets owned by one of APS' affiliates, Pinnacle West Energy Corporation ("PWEC"). Staff has concluded that the Commission should grant this unusual request, subject to conditions, to prevent a potential downgrade to APS' credit ratings. Staff has also concluded that the Commission should deny APS' request to guarantee PWEC's debt, because a guarantee will interfere with APS' ability to have a priority security interest in the PWEC assets.

II. AUTHORIZING APS TO BORROW \$500 MILLION IN ORDER TO LOAN THE PROCEEDS TO PWEC MAY SERVE THE PUBLIC INTEREST BY PROTECTING APS' CREDIT RATINGS.

APS argues that its parent company, Pinnacle West Capital Corporation ("PWCC"), will suffer a credit ratings downgrade if APS does not support the refinancing of PWCC's bridge debt. (Tr. at 72). By contrast, Panda argues that there is no evidence in the record that PWCC will suffer a

1 downgrade if APS does not refinance the bridge debt. (Panda's Br. at 10). Specifically, Panda
2 complains that APS has not introduced any "written" evidence to support its claims. Id. at 11.

3 Panda's argument is somewhat unusual given the issue in dispute: whether the ratings
4 agencies will downgrade PWCC's credit rating. This issue requires the parties to speculate about the
5 future actions of various third parties. To exacerbate the difficulty, rating agencies are not likely to
6 broadcast their intentions. (Tr. at 964). As Staff witness Thornton testified,

7 it's quite often difficult to find a rating agency [that will] pin itself down
8 to any particular action. So one might . . . not normally expect that.

9 (Tr. at 964-65). By claiming that there is no written evidence, Panda is complaining about a lack of
10 documentation for an event that has yet to occur.

11 Understood in this context, the written evidence supporting the potential for a PWCC
12 downgrade is significant. Staff witness Thornton, when asked to identify a rating agency report that
13 signals a potential PWCC downgrade, referred to the following portion of a Fitch report:

14 With PWEC unable to fund itself, P&W is relying on the utility to
15 refinance the majority of the \$790 million of bridge financing debt
16 maturing over the next fourteen months through an intercompany loan.
17 If an intercompany loan is authorized by the ACC, the proceeds will be
18 transferred to P&W and used to reduce parent company debt. It is
unclear whether the ACC will approve the company's \$500 million
financing request. Failure to obtain the intercompany loan or access
alternate sources of funding would result in a downgrade of P&W.

19 (Tr. at 947-48; see also Ex. APS-2, Ex. BMG-2R, Tr. at 220-21). Mr. Thornton also identified a
20 report from Standard & Poor's:

21 The stable outlook [for PWCC] reflects the assumption that the ACC
22 will approve the application by PWCC to issue up to \$500 million at
23 APS to repay a portion of the \$750 million bridge financing at PWCC
that was done to build assets at PWEC The issuance at APS should
relieve liquidity pressure at PWCC.

24 (Ex. S-2; Tr. at 965-66). Finally, APS witness Gomez referred to an article from Moody's:

25 Pinnacle West's rating outlook is stable, and incorporates the view that
26 the ACC will adopt the Staff recommendation concerning the APS
27 financing application, which should allow for a successful refinancing of
28 Pinnacle West debt.

1 (Ex. APS-5; Tr. at 221-24).¹ Although these reports are subject to interpretation, they all imply that
2 the outlook for PWCC is stable as long as APS' financing application is approved.

3 APS could face credit downgrades if PWCC is downgraded. (Tr. at 125-26, 155-56, 184,
4 186). Although Staff witness Thornton admitted that he could not state for a fact that APS will be
5 downgraded, he noted that several rating agencies have intimated as much in their reports. (Tr. at
6 911-13). At the hearing, Mr. Thornton identified a specific rating agency report that rated APS'
7 outlook as stable, assuming that the Commission approves the financing. (Tr. at 950). Although this
8 report is subject to interpretation, it implies that APS' ratings outlook is stable as long as the
9 financing application is approved.

10 A rating downgrade at APS could interfere with APS' ability to provide electric service to the
11 public. A credit downgrade could result in increases in the cost of capital, potential lack of access to
12 the capital markets, potential increases in collateral requirements, and an inability to do business with
13 vendors. (See Tr. at 164-65). APS' requested financing will be compatible with the public interest if,
14 by preventing a downgrade in APS' credit ratings, it prevents a substantial disintegration in APS'
15 ability to provide service. For these reasons, Staff recommends that the Commission authorize APS
16 to borrow \$500 million in order to loan the proceeds to PWEC.

17 **III. BECAUSE OF THE RISKS INHERENT IN THIS TRANSACTION, THE**
18 **COMMISSION SHOULD ATTACH CONDITIONS TO ITS APPROVAL OF APS'**
19 **APPLICATION.**

20 Even though Staff has concluded that APS' prospect financing will likely serve the public
21 interest, the transaction poses some risks to the company and its ratepayers. (Ex. S-1 at 1, 3, 5). To
22 mitigate these risks, Staff proposes seven conditions. (Ex. S-1 at 10-11; Tr. at 906-07). APS has
23 accepted all of the Staff conditions. (APS' Br. at 23). APS does, however, propose a change to
24 condition 3 and a clarification to condition 7. Staff opposes the change to condition 3, but agrees
25 with the clarification to condition 7.

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27
28 ¹ These are not the only examples of rating agency reports that intimate a potential PWCC downgrade. (See Tr. at 948-49, 964-65, 994).

1 **A. Condition 3.**

2 Staff condition 3 imposes a risk premium upon PWEC of 264 basis points above the coupon
3 rate on the APS debt. (Ex. S-1 at 11). APS accepts this concept in principle, but argues that the risk
4 premium is excessive. (APS' Br. at 23). APS witness Gomez supports a 150 basis point spread,
5 rather than Staff's 264 basis points. (Tr. at 102-03). Staff's larger amount, she claims, deals with
6 PWEC as if it were rated BB, which is noninvestment grade. Id. She further argues that PWEC
7 would have had an investment grade credit rating but for the Track A order. Id.

8 By contrast, Staff believes that the loan should be priced at an appropriate market rate, not at a
9 hypothetical rate based upon an unrealized set of circumstances. (Tr. at 919-20). PWEC's current
10 status reflects a BB minus rating, which is noninvestment grade. (Tr. at 935-36). Staff's 264 basis
11 point risk premium is designed to ensure that APS will be compensated for the actual risk associated
12 with lending money to PWEC. (Tr. at 919-20). The Commission should adopt Staff's condition 3 as
13 proposed.

14 **B. Condition 7.**

15 Staff condition 7 requires APS to maintain a minimum common equity ratio of forty percent
16 and to forego paying dividends if the dividend payment would reduce common equity below this
17 threshold. (Ex. S-1 at 12). APS has asked to clarify the method for calculating the equity ratio. APS
18 proposes to calculate the equity ratio on a quarterly basis, using APS' 10-Q or 10-K filings with the
19 Securities and Exchange Commission. Using the reported APS balance sheet accounts, APS would
20 divide the APS common equity by the sum of the common equity and long-term debt, including
21 current maturities of such debt. (APS' Br. at 24; Ex. APS-1 at 6). Staff accepts this clarification.
22 (Tr. at 906-07).

23 At the hearing, Staff also proposed two additional clarifications to condition 7. First,
24 condition 7 should remain in effect indefinitely. Id. Second, Staff added a reporting requirement:
25 APS should file the capital structure calculation with the Commission within one week of filing a 10-
26 Q or 10-K. Id. APS has not objected to these additional clarifications.²

27 ² At the hearing, Staff also proposed a clarification to condition 4. Staff proposed that condition 4's interest cost should
28 be the hypothetical cost following from condition 3. In other words, 264 basis points should be deferred over the life of
the loan and compounded at six percent. (Tr. at 906-07).

1 **IV. THE COMMISSION SHOULD NOT BASE ITS APPROVAL OF THIS**
2 **APPLICATION UPON APS' ALLEGATIONS THAT THE COMMISSION IS AT**
3 **FAULT FOR PWCC'S PREDICAMENT.**

4 Throughout this case, APS has implied that the Commission is responsible for PWCC's
5 dilemma, claiming that the Commission "largely created" this problem "in the first instance." (Ex.
6 APS-1 at 24). Over and over again, APS insinuates that the Commission's Track A order is largely
7 to blame, (APS' Br. at 5, 7), and that the Commission is now responsible for repairing that order's
8 "loose ends." (Tr. at 586). Finally, APS has stated that incurring the bridge debt was "consistent with
9 Commission guidance and directives," (APS' Br. at 8), as if the Commission were the entity that
10 decided to build the PWEC assets and to finance them through short term bridge debt. The
11 Commission should not conclude that it is responsible for PWCC's problems, and it certainly should
12 not base its approval of this application upon such claims.

13 First, all parties to this case acknowledge the turmoil that currently exists in the financial
14 markets and the volatility that has existed in the wholesale electric market. (Ex. S-1 at 3; Tr. at 203-
15 05). Contrary to APS' assertions, it is far from certain that the Track A order is the root cause or
16 even a significant contributing factor to PWCC's dilemma. As Staff witness Thornton stated,

17 I think an interesting argument is really just the opposite. Let's say we
18 had transferred 3,000 megawatts of fossil generation to PWEC, and it
19 had to do financing now. In the current market situation for those
20 type[s] of companies, we could potentially face an even worse problem.
21 So I think it's a very gray area of who's at fault, and I would certainly
22 try to avoid determining fault. This Commission should not feel badly at
23 all, shouldn't feel like it caused this situation.

24 (Tr. at 1009-1110). Mr. Thornton went on to say that it is difficult to determine whether the Track A
25 order mitigated the situation, as in his example, or aggravated it, as the company contends. (Tr. at
26 1110).

27 Second, the PWCC enterprise chose to build the assets at PWEC, chose to finance them at the
28 holding company level, and chose the maturities of the debt. None of these decisions were made or
sanctioned by the Commission. APS will argue that its code of conduct prevented it from building
the PWEC assets at APS, (Tr. at 520); nonetheless, an examination of that document does not clearly
support that conclusion. The code of conduct prohibits APS from providing "interim competitive

activities.”³ This prohibition focuses on services, not on construction. APS’ code of conduct appears to prohibit it from providing competitive retail services, not from constructing plant.

If, as APS claims, the PWEC assets were constructed to serve APS customers, it is perhaps curious that the PWCC enterprise chose to build them at PWEC. However, that was a business decision, possibly influenced by a desire to sell the output from the PWEC assets at wholesale both to APS and to the wider wholesale market. (See Tr. at 529-30). As a business decision, it may yet turn out to be reasonable. Nonetheless, it was not a decision dictated by the Commission.

V. THE COMMISSION SHOULD DENY APS’ REQUEST TO GUARANTEE DEBT ISSUED INDEPENDENTLY BY PWCC OR PWEC.

A. The issue of whether to rate base the PWEC assets has no bearing upon whether to design the transaction as a guarantee instead of a loan.

Panda contends that APS now prefers a loan over a guarantee because APS believes that a loan will make it easier to eventually rate base the PWEC assets. (Panda’s Br. at 26; see also Tr. at 293-94). Panda further argues that APS’ desire to rate base the PWEC assets should not drive the Commission’s decision as to how to structure this transaction. (Panda’s Br. at 26). Perhaps Panda has a point: Staff agrees that the rate base issue is entirely premature and should not be considered at all in this proceeding. Nonetheless, just as APS’ desire to rate base the assets should not dictate the structure of this transaction, neither should Panda’s desire not to rate base the assets similarly influence its structure.

Panda argues that a loan may make it more likely for the PWEC assets to be automatically transferred to APS. (Panda’s Br. at 31). Specifically, Panda is concerned that PWEC will default on the loan and that, in the wake of the default, APS will take possession of the PWEC assets. Id. Panda apparently believes that APS’ acquisition of the PWEC assets will damage the competitive market by reducing APS’ contestable load. Panda’s concern is misplaced. It is not APS’ acquisition of the assets that would reduce its contestable load; it is instead the rate basing of those assets. Of

³ In the code of conduct, “interim competitive activities” are defined as “any Competitive Services, exclusive of those set forth in A.A.C. R14-2-1615(B), that APS may lawfully provide until December 31, 2002.” Decision No. 62416, Ex. A at 2. The term “Competitive Services” is further defined in the code of conduct as “all aspects of retail electric service except those services specifically defined as ‘Noncompetitive Services’ pursuant to A.A.C. R14-2-1601(29) or noncompetitive services as defined by the Federal Energy Regulatory Commission.” Decision No. 62416, Ex. A at 1 (emphasis added).

1 course, the assets cannot be rate based without an order of the Commission. Accordingly, it is not
2 reasonable to structure the transaction to prevent APS from simply acquiring the assets. This would
3 not serve any useful purpose.

4 The fate of the PWEC assets for ratemaking purposes will be based on whether the assets are
5 “used and useful,” i.e., whether the decision to acquire the assets was prudent and whether the assets
6 are actually used to serve customers. It is unlikely in the extreme that the Commission will determine
7 the assets’ rate base treatment based upon whether this transaction is structured as a loan or a
8 guarantee. In other words, the Commission certainly will not rate base \$1 billion in assets merely
9 because a loan is in place, thereby displacing the “used and useful” standard. Although APS may
10 believe that a loan may make it easier for APS to rate base the assets, such considerations are unlikely
11 to influence the Commission’s decision.

12 **B. The Commission should not sacrifice ratepayers’ interests in order to protect the**
13 **interests of the merchant generators.**

14 Panda is reluctant for the Commission to rate base the assets because it is afraid that rate
15 basing will reduce APS’ contestable load. (Panda’s Br. at 28). By contrast, APS is probably anxious
16 for the assets to be rate based because it will give it the certainty of cost recovery and shield it from
17 the vagaries of the wholesale market. At this point, the Commission should be neutral on this issue,
18 because we cannot foresee the future. The wholesale market may be vibrant, yielding fabulous deals
19 for APS and its ratepayers. It may also be a dismal failure. Because we do not know the results of
20 the Track B solicitation, it is simply too early to tell.

21 Panda urges the Commission to design this transaction based solely upon the goal of
22 protecting the wholesale market. But this is premature: we do not yet know whether there is anything
23 worthwhile to protect. True, the Commission has stated that it favors competition. But the
24 Commission, in its Track A order, has also recognized that the competitive wholesale market is
25 dysfunctional and that FERC has been unable to adequately protect ratepayers. Decision No. 65154
26 at 29. In this regard, Track A is both optimistic and pessimistic: it recognizes the need to prevent
27 divestiture in order to protect ratepayers from the wholesale market; it also acknowledges that
28 competition, if structured properly, can bring benefits to ratepayers.

1 In Track A, the Commission wisely recognized that it is too early to determine whether the
2 problems in the wholesale market can be remedied to ensure benefits to ratepayers. Because of these
3 uncertainties, this transaction should not be structured with the goal of increasing APS' contestable
4 load, an action that may benefit merchants such as Panda. Nor should it be structured to make it
5 easier to rate base the PWEC assets, an action that may benefit APS and the PWCC enterprise.
6 Instead, it should be structured to protect ratepayers.

7 The Commission can best protect ratepayers by requiring APS to have a priority security
8 interest in the PWEC assets. (See Tr. at 123-25, 906). In the event of default, APS will then have a
9 sure means of protecting its interests. This is superior to the guarantee option proposed by Panda, in
10 which the PWEC assets would be pledged to a third party to secure a PWEC loan for which APS
11 would provide a guarantee. (Panda's Br. at 32). This would leave APS either without a secured
12 interest or in a secondary position to that of the third party lenders'. This is not adequate protection
13 for ratepayers, especially considering the probability that lenders will prefer to pursue APS on the
14 guarantee before pursuing the PWEC assets. (Tr. at 196-97, 208-09).

15 Panda's proposal is further compromised by its lack of support in the record, which does not
16 establish that the terms of Panda's proposed guarantee are achievable. This lack of certainty makes
17 Panda's proposal impractical in light of APS' claims that this transaction must be accomplished
18 quickly. (Tr. at 987).

19 **VI. THE COMMISSION NEED NOT ACT UPON THE PRINCIPLES OF RESOLUTION**
20 **AT THIS TIME.**

21 The Arizonans for Electric Choice and Competition ("AECC") urge the Commission to reject
22 the portions of the Principles of Resolution that contemplate that APS shall raise its arguments about
23 competition transition costs and the write-off at the Commission before pursuing them in court. The
24 AECC argues that these provisions contravene the 1999 APS settlement agreement without
25 complying with the provisions of A.R.S. § 40-252 and without providing for appropriate Commission
26 consideration at an open meeting. Both of these arguments are premature.

27 The Principles of Resolution do not bind the Commission: they represent an understanding
28 between APS and Staff. Even if the Principles of Resolution require Commission action in order to

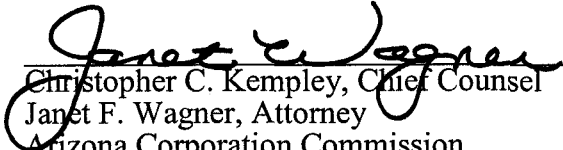
1 become effective, there is no reason to presume that the Commission will not take action at the
2 appropriate time. The Principles of Resolution themselves do not propose to amend Decision No.
3 61973, the Commission order that approved the 1999 settlement agreement. They merely specify
4 that APS may ask for certain relief in its next rate case, which APS was always free to do. (Tr. at
5 582). And to the extent that Commission action is required in order to dismiss portions of APS'
6 Track A appeal, the Commission can convene an open meeting to consider that matter at that time.
7 There is no reason for the Commission to act upon the Principles of Resolution in concert with this
8 application.

9 **VII. CONCLUSION.**

10 Staff recommends the following:

- 11 1. The Commission should authorize APS to borrow \$500 million in order to loan the
12 proceeds to PWECC.
- 13 2. The Commission should condition its approval of this application upon Staff's seven
14 conditions as clarified at the hearing. (Ex. S-1 at 11-12; Tr. at 906-07).
- 15 3. The Commission should deny APS' request to guarantee any debt issued
16 independently by PWCC or PWECC.

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RESPECTFULLY SUBMITTED this 6th day of February, 2003.


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